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BANK RESOLUTION REGIMES: BALANCING PRUDENTIAL REGULATION AND SHAREHOLDER RIGHTS

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A bank resolution regime requires regulators to have the authority and instruments to restructure a bank's operations if its failure threatens the stability of the financial system or undermines other regulatory objectives, such as depositor confidence. Such regulatory action, however, may affect shareholder rights in the restructured bank and possibly reduce the economic value of their ownership interests. The credit crisis of 2007–09 has demonstrated the importance of having a resolution regime that balances the rights of shareholders against the objectives of prudential regulation and crisis management. The constraints of corporate insolvency regimes can be too cumbersome for effective resolution of a banking enterprise, especially during a financial crisis when a failing bank not yet insolvent needs to maintain open lines of credit with other financial institutions and to manage its balance sheet while achieving regulatory objectives. Bank resolution regimes must be designed not only to protect shareholders and creditors, but also to achieve other regulatory objectives that are vital for the efficient operation of the economy. Although the UK Banking Act 2009 provides a comprehensive framework for bank corporate restructuring and insolvency, it creates a mechanism to suspend corporate governance rules pre-insolvency and thus interferes with shareholder rights. This raises important issues under EU company law and the European Convention on Human Rights regarding the protection of property interests in a restructured bank. The article examines the special resolution regime of the UK Banking Act 2009, analyses the relevant issues of EU Company Law and related human rights law and suggests some legal principles to be applied in developing a special resolution regime.

A. INTRODUCTION

The credit crisis of 2007–09 has demonstrated the importance of bank special resolution regimes and the need to balance the competing interests of shareholder rights with the regulatory objectives of financial stability and depositor protection. The constraints of corporate insolvency regimes can be too cumbersome for effective resolution of a banking enterprise, especially during a financial crisis when a failing bank needs to maintain open lines of credit with other financial institutions and to manage its balance sheet while achieving

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regulatory objectives. Bank resolution regimes must be designed not only to protect shareholders and creditors, but also to achieve other regulatory objectives that are vital for the efficient operation of the economy. The UK Banking Act 2009 contains a special resolution regime that seeks to achieve these objectives by striking a balance between the legitimate rights of bank shareholders and depositors while promoting financial stability objectives. The Act grants the Treasury and the Bank of England sweeping powers to restructure a failing bank and to transfer its shares and property to a government-owned bridge bank or to a private purchaser. Although the stabilisation regime provides a comprehensive framework for bank corporate restructuring and insolvency, it authorises the Bank of England to suspend corporate governance rules pre-insolvency and thus interferes with shareholder rights. This raises important issues under EU company law and the European Convention on Human Rights (ECHR) regarding the protection of property rights in a bank that is undergoing restructuring to achieve regulatory objectives.

European corporate law makes it difficult for a regulator to act quickly in saving or restructuring a failing bank because shareholder approval is required if the regulator adopts measures that require a change of the bank's capital structure.¹ This article raises a number of legal and regulatory issues regarding the application of regulatory powers to a failing bank outside insolvency and its impact on shareholder rights under European and US law. The article examines European Community case law regarding the application of regulatory powers to shareholders' rights in banks that are organised as public limited liability companies. Related cases involving the application of the ECHR to shareholder rights in banking corporations and the scope of prudential regulatory power will be discussed as well. The cases and issues discussed have become particularly relevant because the credit crisis of 2007–09 has resulted in substantial erosion of bank balance sheets and led to regulatory calls for banks to raise additional capital from both existing shareholders and outside investors (including the state). The need for many banks to raise additional capital has tested the effectiveness of the laws and regulations governing the capital structure of banks.

¹ C-441/93 *In re Panagis Pafitis and Others*, on the interpretation of Art 25 *et seq* and Art 29 of the Second Council Directive, Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Art 48 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent ([1977] OJ L26, 1). In *Pafitis*, the European Court of Justice ruled, *inter alia*, that Art 25 of the Directive (77/91/EEC), requiring that an increase in capital of a public limited liability company be approved by a general meeting of shareholders, precluded national legislation under which a temporary administrator outside insolvency could order in exceptional circumstances a bank organised as a public limited liability company to increase its regulatory capital to protect depositors without approval of a general meeting of shareholders.

The crisis has led to radical proposals for regulatory reform in Europe and the US. For instance, the UK Banking Act 2009 has attracted much attention because it creates a separate resolution regime for UK banks and grants substantial stabilisation powers to the Bank of England² to take measures against a failing bank that may include raising outside capital, transferring shares and property, as well as contractual rights and liabilities of the bank to another bank or private purchaser, or merging the bank with a state-owned bridge bank or private bank. These sweeping regulatory powers raise important issues regarding the legitimate reach of regulatory power and the scope of shareholder rights under European law. The article will examine some of the main issues in this area and the new special resolution regime under the UK Banking Act 2009.

B. BANKING AND PRUDENTIAL REGULATION

The role of banks is integral to any economy. They provide financing for commercial enterprises, access to payment systems and a variety of retail financial services for the economy at large.³ Some large banks have a broader impact on the macroeconomy by facilitating the transmission of monetary policy and making credit and liquidity available in difficult market conditions.⁴ The integral role that banks play in the national economy is demonstrated by the almost universal practice of states in regulating the banking industry and providing, in many cases, a government safety net that compensates depositors when banks fail and offers lender of last resort facilities for banks having difficulty in accessing credit and liquidity.⁵

The main rationale of prudential bank regulation has traditionally been the safety and soundness of the financial sector and protection of depositors.⁶ A safe

² The Banking Act 2009 amends certain provisions of the Financial Services and Markets Act 2000 and the Banking Act 1998 to establish a Financial Services Compensation Scheme for UK bank depositors, and a special resolution regime for both solvent but failing banks and insolvent banks which would be subject to a special administration or special liquidation procedure.

³ F Allen and D Gale, *Comparing Financial Systems* (Cambridge, MA, MIT Press, 2000), ch 1.

⁴ See J Hawkins and P Turner, "Managing Foreign Debt and Liquidity Risks in Emerging Economies: an Overview" [September 2000] *BIS Policy Papers* 8 <http://www.bis.org/publ/plcy08> (last accessed 15 Jan 2009). See M Dewatripont and J Tirole, *The Prudential Regulation of Banks* (Cambridge, MA, MIT Press, 1995), 17–18.

⁵ See J Stiglitz, "Principles of Financial Regulation: A Dynamic Portfolio Approach" (Spring 2001) 16 *World Bank Research Observer* 1, 1–2.

⁶ Dewatripont and Tirole, *supra* n 4, 25–32. Bank regulation has traditionally sought to mitigate these social costs by adopting various prudential measures to promote safety and soundness, including deposit insurance, capital adequacy requirements, asset composition rules, and fit and proper standards for bank officers, senior management and board members. See the discussion in TL Holzman, "Unsafe or Unsound Practices: is the Current Judicial Interpretation of the Term Unsafe or Unsound?!" (2000) 19 *Annual Review of Banking Law* 425. For a legal definition of "safety and soundness" under US law which does not include systemic risk, see *First National Bank of Bellaire v Comptroller of the Currency*, 697 F 2d 674, 681 (5th Cir, 1983) (defining unsafe and unsound

and sound banking system requires the effective control of systemic risk.⁷ Systemic risk arises because banks have an incentive to underprice financial risk as they do not incur the full social costs of their risk-taking.⁸ The social costs of bank risk-taking can arise from the solvency risks posed by banks because of imprudent lending and trading activity, or from the risks posed to depositors because of inadequate deposit insurance that can induce a bank run.⁹ Systemic risk can also arise from problems with payment and settlement systems, or from some types of financial failure that induce a macroeconomic crisis.¹⁰ Prudential regulation therefore aims to reduce the social costs which bank risk-taking creates by adopting controls and incentives that induce banks to price financial risk more efficiently.¹¹

The social cost of bank risk-taking and the resultant systemic risk make it necessary for banks to have robust corporate governance arrangements that incentivise bank management and owners to understand the risks they are taking and to price it efficiently so as to cover the private costs it may impose on the bank's shareholders and the social costs on the broader economy if the bank fails.¹² Corporate governance plays an important role in achieving this in two ways: by aligning the incentives of bank owners and managers so that managers seek wealth maximisation for owners, while not jeopardising the bank's franchise value through excessive risk-taking; and by incentivising bank management to price financial risk in a way that covers its social costs. The latter objective is what distinguishes bank corporate governance from other areas of corporate

banking practices as "encompass[ing] what may be generally viewed as conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder").

⁷ J Dow, "What is Systemic Risk? Moral Hazard, Initial Shocks, and Propagation" (2000) 18 *Monetary and Economic Studies* 1, 21. See EP Davis, *Debt, Financial Fragility and Systemic Risk* (Oxford University Press, 1995), ch 5. See also Stiglitz, *supra* n 5, 7–8.

⁸ The social cost of bank risk-taking can take the form of a general loss of confidence by depositors in the banking sector (bank run) which will force banks to sell off their assets at prices far below their historic costs. Also, a defaulting bank's uninsured liabilities to other banks or financial institutions can serve as a source of contagion that can create substantial losses for other banks whose unfunded exposures to counterparties derive from the original defaulting bank. Bank risk-taking therefore creates a negative externality for the broader economy that provides the major rationale for banking regulation. See FS Mishkin, *The Economics of Money, Banking and Financial Markets* (Harlow, Pearson, Addison-Wesley, 7th edn, 2004), 271–74.

⁹ Under-priced financial assets can result in imprudent lending and trading activity for banks and lead to increased solvency risks. See Dewatripont and Tirole, *supra* n 4, 23–25. Moreover, the difference between the private costs and the social costs of bank risk-taking is the negative externality imposed on society via depositors, borrowers and other banks. J Eatwell and L Taylor, *Global Finance at Risk* (Cambridge, Polity Press, 2000).

¹⁰ See Dewatripont and Tirole, *supra* n 4, 23–24.

¹¹ Stiglitz, *supra* n 5, 3–5.

¹² H Mehran, "Critical Themes in Corporate Governance" (2003) 9 *FRBNT Economic Policy Review*; see also J Macey and M O'Hara, "The Corporate Governance of Banks" (2003) 9 *FRBNT Economic Policy Review* 91; R Adams and H Mehran, "Is Corporate Governance Different for Bank Holding Companies?" (2003) 9 *FRBNT Economic Policy Review* 123.

governance because of the potential social costs that banking can have on the broader economy.¹³

The social costs that banks pose for the economy also demonstrate the need for a special resolution regime for banks that provides a legal framework for the regulator to decide whether to attempt to save a bank by recapitalisation or other restructuring pre-insolvency and, if this fails, to oversee the unwinding of the bank's multiple positions in insolvency and to sell off its viable assets to other banks or investors.¹⁴ For many countries, including the UK,¹⁵ ordinary insolvency law procedures have applied to the administration and liquidation of a failing bank. Generally, corporate insolvency law applies an elaborate framework to rank the economic claims of creditors and other stakeholders against a firm which is unable or unwilling to honour its financial obligations. Insolvency law may prove socially costly, however, for certain firms, such as banks, because insolvency procedures may result in restrictions on a bank performing its essential function as a financial intermediary in the economy. For instance, insolvency law may result in a stay on payments and a balance sheet freeze, which would make it difficult, if not impossible, for the bank to rely on the wholesale funding markets and to manage its counterparty exposures through netting. The inadequacies of general insolvency law to address the risks which banks pose to the broader economy has led many countries to enact special bank resolution regimes. An important element of these resolution regimes is that they permit the regulator to take certain measures pre-insolvency which may alter or reduce shareholder rights and the claims of third parties in order to protect depositors in the weakened bank and to maintain overall financial stability. The rationale for pre-insolvency intervention is that the regulator should have the authority to take certain measures in response to a rapid loss of market confidence which may result in the bank losing access to the short-term inter-bank loan market and wholesale capital markets which may result in increased systemic risk in the banking system. Through regulatory intervention, a market-based solution may become possible. If a market solution is not possible, however, the intervention may be the first step by the regulator or central bank taking control of the failing bank and transferring its shares and other property, including contractual rights and obligations, to a state-owned

¹³ Moreover, it should be noted that regulatory intervention is necessary to address the social costs of bank risk-taking because the regulator is uniquely situated to assert the varied interests of other stakeholders in society and to balance those interests according to the public interest.

¹⁴ See Consultation Document of the Bank of England, HM Treasury and the Financial Services Authority (FSA), "Financial Stability and Depositor Protection: Special Resolution Regime" (July 2008). See UK Banking Bill 2009, discussed below.

¹⁵ See Consultation Document of the Bank of England, HM Treasury and the Financial Services Authority (FSA) "Financial Stability and Depositor Protection: Strengthening the Framework" (January 2008), 2–4.

bridge bank or a private purchaser. Further steps may involve the bank being declared insolvent and being subject to administration or liquidation.

For special resolution regimes to work effectively, however, it is necessary that the regulator has the authority to act quickly and in certain circumstances to set aside the normal corporate governance rules that usually involve obtaining shareholder approval if the bank is required to take a course of action that may diminish shareholder control rights or their economic rights. In other words, the regulator's exercise of resolution powers pre-insolvency may have the effect of compromising shareholder control rights and any regulatory decision to inject state capital into the bank or to require the bank to raise additional capital from external sources, or to transfer the bank's property to another investor without shareholder assent, could significantly reduce the shareholders' economic rights. This should be contrasted with what might happen if the regulator does not intervene and the bank is declared insolvent. In this scenario, a conservator or administrator could be appointed to manage the bank's assets and business operations or, alternatively, a receiver or trustee could be appointed to liquidate the bank's operations.¹⁶ Essentially, insolvency would mean that shareholder control and governance rights would terminate and the shareholder would be left with only a residual monetary claim against the assets of the bank's estate.¹⁷ The exercise of regulatory powers in a special resolution regime raises a number of important legal and regulatory issues regarding how to balance prudential regulatory objectives and shareholder rights. To examine this, it is necessary to analyse the substance and scope of shareholder rights under the ECHR and European Community law.

C. SHAREHOLDER RIGHTS AND INTERESTS

In defining shareholder rights, international law has generally made a distinction between the rights and interests of shareholders. In the *Barcelona Traction* case, the International Court of Justice (ICJ) observed that a public company with limited liability is founded on the distinction between the rights of the company and those of the shareholders.¹⁸ Although a wrong committed against a company may infringe the shareholders' economic interests, it may not infringe their rights. The ICJ ruled that whenever a shareholder's interest is harmed by a measure directed at the company, it is the company's legal right, not the

¹⁶ See GN Olson "Government Intervention: The Inadequacy of Bank Insolvency Resolution—Lessons from the American Experience" in RM Lastra and HN Schiffman (eds), *Bank Failures and Bank Insolvency Law in Economies in Transition* (The Hague, Kluwer Law International, 1999), 114, 134–36.

¹⁷ See E Hüpkes, *The Legal Aspects of Bank Insolvency: A Comparative Analysis of Western Europe, the United States and Canada* (The Hague, Kluwer Law International, 2000), 54.

¹⁸ *Barcelona Traction, Light and Power Company Limited*, ICJ Reports (1970) paras 56–58.

shareholder, to take appropriate action.¹⁹ In other words, an act that only infringes the company's rights, and not those of the shareholders, does not involve legal responsibility towards the shareholders, even though the shareholders' economic interests may be harmed. Under international law, the state (or states) of the shareholders' nationality has standing to seek redress on behalf of the shareholders against a foreign state if that state has committed an act that is directed at, or infringes, shareholder rights or if the company is wound up.²⁰

The European Court of Human Rights (ECtHR, the Strasbourg Court) has also addressed the nature of shareholder rights. In *Olczak v Poland*, the court recognised that a share was "a complex object" and that a shareholder in a company had corresponding rights which encompassed "a share in the company's assets in the event of its being wound up, and other unconditioned rights, especially voting rights and the right to influence the company's conduct".²¹ In *Olczak*, the court observed that shares in a public company have economic value and therefore can be regarded as "possessions" within the meaning of Article 1 of Protocol 1 of the ECHR.²² The share is not only an indirect claim on company assets, but can include other rights as well, especially voting rights and the right to influence the company.²³

In most European jurisdictions, shareholder rights can be divided into (i) economic or pecuniary rights, and (ii) control or governance rights. Economic rights can include the right to receive the remaining value of a company after it is liquidated or wound up in insolvency. Control rights can include the right to influence the company's decision-making and strategic direction.²⁴ More specifically, shareholder rights usually cover the right to vote at general and special meetings to elect directors,²⁵ to approve the sale of certain company

¹⁹ *Ibid*, para 58. In *Barcelona Traction*, the ICJ held that only the state of the company's nationality, and not the state of the shareholders' nationality, could bring a claim on behalf of the company against a foreign state for an alleged breach of international legal rights involving a breach of legal duty to a company. The principle is stated under domestic English law as the rule in *Foss v Harbottle*. (1843) 2 Hare 461. See also *Bamford v Bamford*, [1980] Ch 212.

²⁰ *Ibid*, para 66. In contrast, a shareholder's economic interests in a company were related to the company's future prospects and thus were not legally cognisable interests.

²¹ *Olczak v Poland*, ECtHR (7 November 2002) (final decision as to admissibility), 12 (citing ECHR [decision] App No 11189/84, *S and T v Sweden* (11 December 1986), DR 50, 158).

²² *Ibid*.

²³ *Soertransvto Holding v Ukraine*, ECtHR, No 48553/99 (December 2001), 4–5 (citing *S and T v Sweden*, *supra* n 21).

²⁴ In most European jurisdictions, shareholders can usually act in concert without burdensome regulatory reporting requirements to influence the board. For instance, some jurisdictions only require 5 or 10% of a class of voting shares to propose resolutions, put issues on the agenda or call extraordinary shareholder meetings. In contrast, US law imposes extensive disclosure requirements on the communications and actions of shareholders who act in concert and together control 5% or more of a class of voting shares in a public company.

²⁵ See J Dine, *Company Law* (London, Sweet & Maxwell, 2001), 120–21 (discussing English case law on the equitable constraints of a shareholder exercising its right to vote). Moreover, in many civil

assets, and to amend the company articles or charter. In addition, most jurisdictions require that shareholders vote on important structural changes in the company, such as acquisitions and mergers, and whether the company will be liquidated. Shareholders who own the same class of shares have a right to be treated equally, and they are residual claimants who have a right to receive a pro-rata portion of the company's profits and assets, giving them a direct economic interest in the success and profitability of the company. Minority shareholders who vote against company reorganisations or major transactions (eg acquisitions and mergers) are entitled to benefits which are approximately equal to those received by controlling shareholders.

As discussed below, the Second Company Law Directive provides shareholders in a public limited liability company with the right to approve any proposal by the board or other party to increase or reduce the share capital of the company.²⁶ Moreover, the Directive lays down procedures²⁷ for an offer of subscription on a pre-emptive basis which must be offered to the shareholders of a public limited liability company whenever the capital is increased by consideration in cash.²⁸ This raises the important issue of pre-emptive rights for shareholders in public companies and how it is regulated under EC law.²⁹ Pre-emptive rights entitle a shareholder to be offered the right to purchase a proportionate number of shares in order to maintain its percentage of ownership and voting control. By having the right to approve the decision of directors to alter the company's capital, shareholders can attach conditions to the issuance of new shares which can prevent the dilution of their equity interest in the company and the loss of their control rights.³⁰

Under US law, the primary source for shareholder rights is state law.³¹ As with most European jurisdictions, common shareholders are viewed as residual

law jurisdictions, shareholders would have a right to elect directors to the supervisory board. This is the case, for instance, under French and German law. See M Menjucq, "Corporate Governance Issues in France" in JJ Norton and J Rickford (eds), *Corporate Governance Post-Enron* (London, British Institute of International and Comparative Law, 2006), 101–15 and UH Schneider, "Corporate Governance Issues in Germany—Between Golden October and Nasty November", *idem*, 143–50.

²⁶ Directive 77/91/EEC (13 December 1976), Art 25. See C Villiers, *European Company Law—Towards Democracy?* (Aldershot, Ashgate/Dartmouth, 1998), 34, 137–41 (discussing the Directive's requirement of minimum capital, maintenance of share capital, and rules for shareholder approval of an increase or reduction in capital).

²⁷ Art 29 (3). See E Ferran, *Principles of Corporate Finance* (Oxford University Press, 2007), 136–37, discussing UK implementation and procedures.

²⁸ Art 29 (1). See ECJ's discussion in *Pafatis*, para 29.

²⁹ Arts 25 and 29 of Directive 77/91/EEC have provided the legal basis for the adoption of pre-emptive rights for shareholders in public limited liability companies in EU states. For an analysis of the regulatory requirements for rights issues under EC and UK law and a critique that they are too cumbersome along with options for reform, see E Ferran, "What's Wrong With Rights Issues?" (2008) 2 *Law and Financial Markets Review* 523.

³⁰ Art 25 of Directive 77/91/EEC.

³¹ See generally M Eisenberg, "The Structure of Corporation Law" (1989) 89 *Columbia Law Review* 1461.

claimants of the corporation because of their claim on profits and assets upon liquidation.³² Regarding control rights, common shareholders can vote for directors to act on their behalf. The legal relationship, however, between the shareholders and the directors is not legally one of agency, as the “principals (the shareholders) do not control the decisions of the agent (the directors)”.³³ Upon election, the directors have fiduciary duties to act in the best economic interests of the company and all its shareholders, not simply for the shareholders who elected them. Under the majority of state statutes, ordinary business decisions are made by the Board, while structural or governance decisions are made by the shareholders.³⁴

Regarding pre-emption rights under US law, the federal securities laws do not afford shareholders with pre-emption rights. US commentators rationalise this by arguing that shareholders in a publicly traded corporation are less concerned with pre-emptive rights “because they are passive investors and have no expectation of maintaining their percentage ownership”.³⁵ The stock exchange rules of several major US exchanges, however, provide strong shareholder voting rights which corporations must adhere to in order to keep their listing. For example, the New York Stock Exchange requires shareholder voting and approval for a company to issue new shares if the new shares significantly dilute the existing value of shares.³⁶ Nevertheless, US pre-emption rights are generally more limited than those offered under the company laws of most EU states.³⁷ Indeed, the availability of pre-emption rights for shareholders in public limited liability companies under Article 29 of the Second Directive suggests that

³² See Revised Model Business Corporation Act (RMBCA), s 6.03 (c) (requiring that outstanding shares have unlimited voting rights and that are entitled to receive the net assets of the corporation upon dissolution).

³³ R Pinto and DM Branson, *Understanding Corporate Law* (New York, Mathew Bender & Co, 1999), 93.

³⁴ In certain circumstances, however, the Board can take governance decisions as well. A majority of state statutes permit the board to decide matters which are also listed as shareholder rights, but the shareholders have a right to override the decision taken by the board. See RMBCA, s 10.20 (bylaws giving the board the power to amend the bylaws also provide the shareholders with power to override the board’s amendments).

³⁵ See Pinto and Branson, *supra* n 33, 73. They also argue that the “mechanics” of first offering newly issued shares in public markets would be unduly burdensome if the shares granted pre-emptive rights.

³⁶ New York Stock Exchange Euronext Listed Company Manual, s 312 (d), which provides that ‘[s]hareholder approval is required prior to an issuance that will result in a change of control of the issuer.’ Section 312 (c) defines control as ‘voting power equal to or in excess of 20 percent’, or ‘the number of shares equal to or in excess of 20 percent of the number of shares of common stock outstanding before the issuance of the common stock’.

³⁷ For example, US state corporation laws have a variety of approaches regarding how pre-emption rights are treated. Under Delaware law, there is a presumption of no pre-emption rights unless they are provided expressly in the Arts. DGCL, § 102(b)(3). Other states, such as New York and Florida, provide for pre-emption rights unless a company expressly opts-out in its Arts.

shareholders in European companies have stronger legal protections against the alteration or change without their consent of the capital structure of public companies. Member state law or a company's charter cannot derogate from this right.

Generally, shareholders in US companies exercise a more limited number of substantive powers that include the election of directors and approval of amendments to the charter or bylaws, acquisition and mergers, the sale of substantial corporate assets, and voluntary dissolution. Shareholders in European companies, by contrast, are statutorily mandated to vote on more strategic matters, such as whether to spin-off divisions or, in the case of capital raising, whether to alter or increase the company's capital, including whether to waive pre-emptive rights related to an increase in company capital.

Some commentators argue that the rights of shareholders are more firmly implanted under European law than US law.³⁸ It is argued that US corporation law allows the articles and bylaws to be written in a way that places most governance power with the board.³⁹ For instance, the limitation of shareholder rights under some US state laws can be demonstrated in the case of Delaware, a popular state for registration and as a headquarters for many major US corporations.⁴⁰ In contrast, under most European jurisdictions, the shareholders' meeting is the source of most governance powers that are not given by statute to the board. Company charters or shareholder resolutions are prohibited from delegating power to the board that is statutorily mandated to be exercised in the shareholders' meeting.⁴¹ Thus, shareholders in European Economic Area (EEA) companies exercise more governance powers over the internal operations of the company than do shareholders in US companies.

³⁸ Hüpkens, *supra* n 17.

³⁹ This view appears to be supported by Delaware law. DGCL, § 141(a) stipulates that "[t]he business and affairs of every [corporation] shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation".

⁴⁰ The Delaware General Corporation Law (DGCL) provides that the Arts of incorporation may contain "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the shareholders." Thus, the board typically holds all powers that are not explicitly reserved for the shareholders.

⁴¹ Limited exceptions exist where the statute authorises such a delegation, for instance, regarding limits of the transfer of shares.

D. THE PROTECTION OF BANK SHAREHOLDER RIGHTS

1. The ECHR⁴²

A shareholder's ownership interest in a company's capital stock has been recognised as protected "possessions", and is thus a property right under Article 1 of Protocol 1 of the ECHR.⁴³ The article states:

"Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties."

The European Court of Human Rights (the Strasbourg Court) has interpreted the provision to be composed of three rules: first, the principle of the peaceful enjoyment of property; secondly, no one shall be deprived of property except subject to conditions prescribed by law and in the public interest; and thirdly, contracting states are entitled, among other things, to control the use of property according to the general interest. The ECtHR observed that '[t]he three rules are not, however, "distinct" in the sense of being unconnected', and '[t]he second and third rules are concerned with particular instances of interference with the right to lawful enjoyment of property and should therefore be construed in the light of the general principle enunciated in the first rule.'⁴⁴ In considering Article I, the court has observed that a "company share is a complex thing". It certifies that the holder possesses a share in the company together with corresponding rights. This is an indirect claim on not only company assets "but other rights, especially voting rights and the right to influence the company, which may follow the share".⁴⁵

The Strasbourg Court has ruled that shares in a company have economic value and therefore constitute "possessions" within the meaning of Article 1 of Protocol 1.⁴⁶ In *Sovtransavto Holding v Ukraine*, the applicant company initially held a 49% stake in a Ukrainian company Sovtransavto-Lugansk. Following the decision of a state agency ordering the company to raise significantly more

⁴² Protocol No 1 to the Convention for the Protection of Human Rights and Fundamental Freedoms, 312 UNTS 221 (adopted at Paris on 20 March 1952; entered into force on 18 May 1954; hereinafter ECHR Protocol).

⁴³ Art 1 of Protocol No 1, European Convention of Human Rights.

⁴⁴ *Beyeler v Italy*, ECtHR, No 33202/96 (Judgment, 5 January 2000) 23. Moreover, the court stated in paragraph 111 that "[a]ny interference with the enjoyment of a right or freedom recognised by the Convention must, . . . pursue a legitimate aim". *Ibid*, 111.

⁴⁵ See *S and T v Sweden*, *supra* n 21.

⁴⁶ *Sovtransavto Holding v Ukraine*, ECtHR (27 September 2001), 937.

outside share capital, the percentage held by the applicant company was reduced to 20.7%. The relative decline in the applicant company's share holdings in the company had the result of limiting its ability to influence the direction and management of the company and protect its investment. The Court held that the manner in which the domestic court proceedings were conducted and resolved, and the uncertainty in which the applicant shareholder was left, upset the "fair balance" that was required to be struck between the demands of the public interest and the need to protect the applicant shareholder's right to the enjoyment of its possessions. Consequently, the state failed to comply with its obligation to secure to the applicant shareholder the effective enjoyment of its property right. The case supports the view that Article 1 of Protocol 1 protects shareholders against direct and indirect forms of property deprivation and interference by governmental authorities.

Of particular significance to financial holding companies, conglomerates and institutional investors, it should be emphasised that the protection of private property under the ECHR applies to "every natural and legal person".⁴⁷ Accordingly, the protections of the ECHR are applicable to companies or other business entities who are shareholders in other companies, which means, for example, that shares in banking companies owned by parent companies would attract property rights protection under the ECHR. Moreover, the Strasbourg Court has interpreted Article 1 of Protocol 1 as having a broad application that includes the rights of shareholders in a public company who, as a result of a merger between their company and another company, were obliged to exchange their shares in the former company for shares in the latter company at an unfavourable rate.⁴⁸ The Court held that the protection sought by the shareholder could include a guarantee that the terms of the share exchange were appropriate and did not constitute an unlawful deprivation of property.⁴⁹ Nevertheless, the court recognises that these rights are not absolute and may be restricted in a number of ways, provided that certain legal protections are observed.⁵⁰

2. EU Legislation

EU Company Law Directives provide strong protections for certain shareholder rights.⁵¹ The Second Company Law Directive (Second Directive) contains the

⁴⁷ Art 1(1) ECHR Protocol (first sentence of the Protocol).

⁴⁸ *Offerhaus and Offerhaus v the Netherlands*, No 35730/97 (16 December 2001).

⁴⁹ *Ibid.*

⁵⁰ *Ibid.* In addition, Art 6(1) ECHR suggests that property rights in shares are "civil rights", which means that disputes concerning a state's interference in property rights in shares must comply with guarantees of due process. See discussion below.

⁵¹ The Second Directive, 77/91/EEC (formation of public companies and change of capital approval); the Third Directive, 78/855/EEC of 9 October 1978 based on Art 54(3)(g) of the Treaty concerning mergers of public limited liability companies, [1978] OJ L295, 36–43 (Art 7

rules for formation of a public limited liability company and for the equal treatment of shareholders who own the same class of shares in approving the capital structure of their company.⁵² To this end, Article 25(1) requires that the shareholder general meeting approve any alteration, increase or decrease in the company's subscribed capital.⁵³ Moreover, shareholder approval at the general meeting is required to authorise the board to restrict or withdraw the pre-emption rights of existing shareholders.⁵⁴ Indeed, a shareholder's right to maintain its proportional share of its holding in the issued capital of a public limited liability company has been recognised by the European Court of Justice (ECJ) as an inherent right for shareholders.⁵⁵ Shareholders may approve an opt-out, however, from their pre-emption rights for a maximum period of five years by passing a resolution at a general meeting.⁵⁶

The ECJ has interpreted the Second Directive as protecting the rights of shareholders against any change without approval of the company's capital structure, internal governance procedures and formation.⁵⁷ The most important ECJ case to deal with regulatory intervention in the governance of a banking company's capital structure was *Panagis Pafitis v Greece*.⁵⁸ In *Pafitis* the court

provides that a merger requires the approval of the general meeting of each of the merging companies). Sixth Council Directive 82/891/EEC of 17 December 1982 based on Art 54(3)(g) of the Treaty, concerning the division of public limited liability companies, [1982] OJ L378, 47–54 (Arts 5 and 6 on company spin-offs); Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, [2004] OJ L142, 0012–23 (provides for “squeeze-out” rights of the majority shareholder and “sell-out” rights of minority shareholders in the context of takeover bids).

⁵² See Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Art 48 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, [1977] OJ L26, 0001–13. The numbering of Art 48 was changed from Art 58 of the Treaty by Art 12 of the Treaty of Amsterdam. See CJ Hopt and E Wymeersch *European Company and Financial Law* (Oxford University Press, 2004), 284.

⁵³ Art 25(1) of the Second Directive. Similar provisions apply to any reduction of subscribed capital.

⁵⁴ Art 29(4) of the Second Directive. See Case C-338/06 *Commission of the European Communities v Kingdom of Spain*, judgment of 18 December 2008 (declaring that Spain's law granting pre-emptive rights in shares to convertible bondholders and pre-emptive rights in convertible bonds to convertible bondholders, and by failing to provide that the shareholders' meeting may decide to withdraw pre-emptive rights for shareholders in bonds convertible into shares, violated Art 29 of the Second Council Directive).

⁵⁵ *Siemens AG/Nold* [1996] ECR I-6017, opinion of 19 September 1996, para 15 (cited in *Commission of the European Communities v Kingdom of Spain*, *supra* n 54, paras 23 and 26).

⁵⁶ Art 40 of the Second Directive. The resolution can be renewed without limit based on one of two types of majority vote: (i) two-thirds of the shares entitled to vote at the meeting; or (ii) if 50% or more of the shares entitled to vote are present at the meeting, then a simple majority is required to carry the resolution.

⁵⁷ C-19/90 and C-20/90 *Karellas v Minister for Industry, Energy and Technology and Organismos Anasygkrotiseos Epicheiriseon AE* [1991] ECR I-2691, para 30; and C-381/89 *Syndesmos Melon tis Eleftheras Evangelikis Ekklessias and others v Greek State and others* [1992] ECR I-2111, para 27.

⁵⁸ C-441/93 *Pafitis and Others v TKE and Others* [1996] ECR I-1347.

reviewed a Greek banking regulation that allowed the Greek National Bank to appoint a temporary administrator to manage the affairs of a bank that took the form of a public limited liability company under Article 25 of the Second Directive. The bank was heavily indebted and posed a serious risk to depositors, and thereby threatened banking stability. Under the regulation, the administrator suspended the governance rights of the shareholders and passed resolutions increasing the bank's share capital. The government initially subscribed to shares which gave it a controlling interest in the bank. Later, the administrator directed the bank to issue more shares through several rights issues, in which existing shareholders were offered to purchase a proportional amount of shares. The original shareholders refused these offers, however, because their interest had been significantly diluted when the government initially injected capital. The Greek court upheld the administrator's authority to reorganise the bank and to raise capital without shareholder approval on the grounds that banking corporations were subject to a different set of supervisory laws and that this justified derogation from the shareholder rights protections in Article 25 of the Directive. The ECJ overruled the national court by holding that under these circumstances Greek banking law could not derogate from the minimum protections afforded shareholders in public limited liability companies under the Second Directive.⁵⁹

The court's judgment acknowledged that considerations to protect the interests of depositors and, more generally, banking stability required strict supervisory rules, but it did not agree that the sweeping powers granted to the administrator to reorganise the heavily indebted bank without shareholder approval was necessary to protect depositors. The exercise of these powers to recapitalise the bank without shareholder approval therefore violated the minimum standards of shareholder protection in Articles 25 and 29. The court accepted the Advocate General's argument that the Greek supervisory rules were not necessary to achieve the regulatory objectives, as these could have been achieved by other means, such as through a comprehensive deposit insurance scheme, which would have achieved the same regulatory objective of protecting depositors while not interfering with shareholder rights under Article 25. In other words, it was possible in this case for the Member State, if its regulations did not meet the requirements of the Directive, to adjust its supervisory rules to achieve both their regulatory objectives and the minimum requirements of shareholder protection. Moreover, the court observed that the bank reorganisation measures which Greek authorities had taken were not "execution" measures in the sense that they could suspend company governance rights. Crucially, the court stated:

⁵⁹ The ECJ cited its reasoning in *Karella* [1991] ECR I-2691, para 30; and *Syndesmos Melon* [1991] ECR I-2691, para 27.

“the directive does not, admittedly, preclude the taking of execution measures intended to put an end to the company’s existence and, in particular, does not preclude liquidation measures placing the company under compulsory administration with a view to safeguarding the rights of creditors. However, the directive continues to apply where ordinary reorganization measures are taken in order to ensure the survival of the company, even if those measures mean that the shareholders and the normal organs of the company are temporarily divested of their powers.”⁶⁰

The court held that the appointment of a temporary administrator under Greek law did not resemble an “execution measure” or even a “liquidation measure”, even though all the powers and competencies of the company organs were transferred to the administrator.⁶¹ The court made a distinction between the measures that could have been taken under Greek law that would have resulted in the withdrawal of the bank’s licence and its liquidation, and the appointment of a temporary administrator that would allow the bank to continue its operations as before. Indeed, the vesting of all powers and competencies of the organs of the company with the administrator was only temporary and all subsequent capital increases following the initial one directed by the temporary administrator were approved by the new shareholders. This proved that the company was not executed into insolvency and that the appointment of the temporary administrator was to ensure the company’s survival and therefore could not justify extinguishing the rights of the original shareholders, thus violating shareholder rights under Articles 25 and 29 of the Directive.

The *Pafitis* case establishes the importance of protecting a shareholder’s minimum control and economic rights in a company, even if there is an important regulatory objective for interfering with these rights.⁶² EU Member States may not adopt bank regulatory measures that infringe minimum shareholder rights, including their right to approve any change in the capital structure of the banking corporation or to purchase shares pre-emptively, or to approve the acquisition or merger of the bank or a spinoff of one of its divisions. Some commentators argue that the ECJ would decide the case differently today⁶³ because when the ECJ made its decision in 1996 Greece had

⁶⁰ *Ibid*, para 57.

⁶¹ *Ibid*, para 58.

⁶² *Ibid*, para 60. See Hupkes, *supra* n 17, 63 (arguing that “had the Directive on the reorganization and winding-up of credit institutions been adopted, the conclusion reached by the court might have been different” because “[t]he Directive could have been considered as *lex specialis posterior* and the Greek administration measure could have been recognized as a ‘reorganization measure’ within the meaning of the Directive”). See discussion below.

⁶³ See E Hupkes, “Learning Lessons and Implementing a New Approach—Bank Insolvency Resolution in Switzerland” in DG Mayes and A Liuksila (eds), *Who Pays for Bank Insolvency?* (New York, Palgrave, 2003).

not fully implemented the Second Directive and the Winding-up Directive of 2001 had not been enacted.⁶⁴

The Winding-up Directive of 2001 provides “‘reorganisation measures’ as measures which are intended to preserve or restore the financial situation of a credit institution and which could affect third parties’ pre-existing rights”. The definition of “third parties’ pre-existing rights” is crucial for determining whether reorganisation measures can limit pre-existing shareholder rights. If the definition includes shareholder rights, then such rights can be restricted in derogation from the Company Law Directives in a bank reorganisation outside insolvency.⁶⁵ If a narrower definition is adopted, however, then reorganisation measures would presumably apply only to creditors, such as depositors, and other third party claimants against the bank, and would not therefore interfere with shareholder rights under EU law. It has been suggested that the European Commission should compile a list of national regulatory measures that Member States could take to reorganise a bank outside insolvency which could derogate from shareholder rights under EU directives and European Human Rights law.⁶⁶ In the meantime, the *Pafitis* case remains the law and suggests that the Second Directive prohibits Member State authorities from suspending shareholder rights (except in cases of absolute necessity) in order to provide a temporary administrator with authority to inject state capital into a weakened bank on an expedited basis or to entice new investors which will dilute the equity interests of existing shareholders.

E. REGULATORY ACTION AND SHAREHOLDER RIGHTS

A financial crisis can lead to a sudden loss of investor confidence in a bank’s securities and may require a regulator to act quickly outside of normal corporate governance rules to recapitalise or restructure it. Europe and the US take different approaches. Under EU law, regulators are restricted from acting quickly in restructuring a bank which is not insolvent without *ex ante* shareholder approval. For instance, if a regulator requires a bank to recapitalise itself by issuing new shares, the Second Directive requires that a majority of shareholders approve the recapitalisation and that the shareholders have pre-emption rights over the newly issued shares. Although most EU state regulators have authority

⁶⁴ See Directive on the reorganisation and winding up of credit institutions (Directive 2001/24/EC of 4 April 2001) [2001] OJ L125, 5.5 (hereinafter the Winding up Directive). The EU insolvency regime today consists of one regulation on insolvency proceedings (Council Regulation (EC) No 1346/2000 of 29 May 2000) and another directive concerning the reorganisation and winding-up of insurance undertakings (Directive 2001/17/EC of 19 March 2001).

⁶⁵ RM Lastra, *Legal Foundations of International Monetary Stability* (Oxford University Press, 2006), 133–34.

⁶⁶ *Ibid.*

to take measures that may affect shareholder control or economic rights, they must ordinarily obtain majority approval by shareholders. In contrast, US federal banking law allows the regulator broad discretion to order an ailing bank to take prompt corrective action to recapitalise itself or to take some other action that could alter the governance rights of shareholders without their approval. These different approaches present various degrees of regulatory intrusiveness into the corporate governance of banks and will be discussed below.

1. Pre-intervention Measures

Banking supervision involves the supervisor monitoring the financial health of the bank and in certain circumstances calling upon bank managers to strengthen the bank's position by enhancing its regulatory capital, changing the composition of its assets, reducing the concentration of its asset exposures or other prudential measures. Such supervisory guidance may in the first instance be voluntary and merely an effort by the supervisor to inform the bank of perceived regulatory weaknesses. Under US prompt corrective action, the regulator may, before deciding whether to impose mandatory measures, exhort bank management to increase regulatory capital by, for instance, recapitalising itself.⁶⁷ In this scenario, it would be the decision of management and in some states it would require shareholder approval to increase the bank's capital. Similarly, the Chairman of the French Banking Commission can invite the bank managers or shareholders to take corrective action to cure any perceived regulatory weaknesses.⁶⁸ The UK Financial Services Authority (FSA) has followed a flexible risk-based approach in which supervisors engage in a dialogue with bank management and use voluntary guidance to influence the bank's prudential practices.⁶⁹ Through dialogue and veiled pressure, most banks are likely to take corrective measures to satisfy the concerns of their supervisor. In certain cases, however, more forceful regulatory action may be necessary.

2. Limitations on Shareholder Rights

Shareholder rights in a bank may be restricted by prudential regulatory action pre-insolvency. Indeed, the Core Principles of Banking Supervision recommend that supervisors have the authority to establish fit and proper requirements for bank directors, which limits whom shareholders can vote for as directors.⁷⁰ The

⁶⁷ Section 38(a) of the Federal Insurance Corporation Act of 1991 sets forth the statutory requirements for a well-capitalised bank and the various stages of regulatory intervention all the way from voluntary guidance to a cease and desist order and sanctions.

⁶⁸ Art L511-42 of the Monetary and Financial Code.

⁶⁹ See Financial Services Authority, "Financial Stability and Depositor Protection: FSA Responsibilities" Discussion Paper (December 2008), 5 (referring to the earliest stage of risk-based regulation).

⁷⁰ Core Principles for Effective Banking Supervision, Principle 3.

Core Principles also restrict the acquisition of controlling interest in a banking institution to those investors who can demonstrate compliance with prudential safeguards (ie source of strength requirements).⁷¹ Regulatory restrictions on management may include large exposure limits on the banks lending portfolio and asset allocation rules for the bank's proprietary trading. During a financial crisis, many jurisdictions provide that regulators may suspend shareholder corporate governance rights and procedures in order to protect depositors and to restore a bank's financial health.⁷² As discussed in *Pafatis*, special resolution procedures for banks may provide for a conservatorship whereby the regulator or central bank appoints an official to take control of the bank's operations. Such action may interfere with shareholder control rights and may also lead to a suspension of more fundamental rights, such as the right to elect directors, to call a special shareholder meeting and to submit resolutions to elect new—or remove existing—directors.⁷³ The value of the shareholders' interest may be further depleted or eliminated if the regulator decides to transfer some or all of the bank's viable assets to a state-owned bridge bank or to sell them to a private purchaser, such as another bank, while leaving the original bank with mostly unviable assets.⁷⁴ In some cases, regulatory action may lead to the bank's financial health being restored, in which case pre-resolution shareholder rights would be restored.

⁷¹ Core Principle 4.

⁷² For example, the Bank of Italy can suspend shareholder rights at the general meeting and appoint a special administrator who has the authority to convene a general meeting and to increase the bank's capital stock if the Minister of Economy and Finance has issued a decree to increase, underwrite or guarantee an increase in the bank's capital stock. Law Decrees No 155 of 9 October 2008 and No 157 of 13 October 2008. Similarly, the German Banking Act was amended in 2009 to allow the German supervisory authority BaFin to suspend current bank management and appoint a temporary administrator who can authorise an increase in bank capital without shareholder approval.

⁷³ Under French law, the Banking Commission can appoint a temporary administrator with powers to manage and act on behalf of the bank. Arts L613-18 and L613-22 of the Monetary and Financial Code. Similarly, the Belgian Banking, Finance and Insurance Commission (BFIC) can appoint a special inspector with enhanced administration powers. Swiss law also provides the regulator with powers to appoint a special administrator to govern the bank's affairs and more extended powers. Art 23-*quater* of the Swiss Banking Act. Moreover, the Swiss regulator can likewise impose a forced reorganisation with changes to the capital structure that are not subject to shareholder approval. See Art 29, s 3 of the Swiss Banking Act; see Hupkes, *supra* note 17, 70–74. See also RH Weber and T Iseli, "Das Interne Kontrollsystem im Aktien- und Versicherungsaufsichtsrecht" (2008) 1 *Haftung und Versicherung* 19.

⁷⁴ Norwegian law provides for a public administration regime that allows for a compulsory reorganisation and override of the shareholders. The Norwegian supervisor may stipulate that the share capital shall be increased by a new subscription for shares and designate eligible investors to subscribe for the shares, thus diluting existing shareholders. Sections 3–5 of the Act on Guarantee Schemes for Banks and Public Administration etc, of Financial Institutions (Guarantee Schemes Act) of 6 December 1996 (as amended per 1 July 2004). Similarly, the French Banking Commission may request the courts to order the transfer of shares to another entity. Art L613-25 of the Monetary and Financial Code.

F. LEGAL PRINCIPLES TO INFORM REGULATORY POLICY DEBATE

Shareholder rights have been recognised as rights to property under the ECHR and are given protective status under European Community legislation. Nevertheless, the exercise of shareholder rights are subject to a number of qualifications and conditions as set forth in national laws and regulatory regimes. The ECHR has been interpreted as balancing these competing interests while recognising legitimate expectations in property rights and the state's prerogative to regulate the economy and to take extraordinary measures during a crisis. State oversight of the banking sector and the exercise of regulatory authority should be anchored in certain legal principles. In designing financial regulation, incentives structures should be developed for both *ex ante* prudential regulation and *ex post* crisis management measures that emphasise market-based solutions to financial sector failures while providing adequate state resources to manage a crisis effectively and to contain any spillover effects onto the broader economy. The regulatory regime should also incentivise shareholders to take on more responsibility for recapitalising a troubled bank and redesigning compensation for management so that the bank's risks are more efficiently allocated between long- and short-term investments.

1. The Principle of Legality

The principle of legality encompasses legal certainty and coherence. This requires that regulatory action that interferes with property rights be based on a coherent legal framework in which the conditions justifying the regulator's action must be set out in law or regulation. This principle of legality has been recognised by the Strasbourg Court and is reflected in the language of Article 1 of Protocol 1.⁷⁵ In addition, the principle is reflected in the comprehensive legal framework governing bank shareholder expectations under the US prompt corrective action regime. In section 302(a) of the Federal Deposit Insurance Corporation Act of 1991 the US Congress expressly defined a "risk-based assessment system" as:

"a system for calculating a depository institution's semiannual assessment based on—

- (i) the probability that the deposit insurance fund will incur a loss with respect to the institution, taking into consideration the risks attributable to—
 - (I) different categories and concentrations of assets;
 - (II) different categories and concentrations of liabilities, both insured and uninsured, contingent and non-contingent; and

⁷⁵ Indeed, Art 1 of Protocol 1 states in the relevant part that "[n]o one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law".

- (III) any other factors the [Federal Deposit Insurance Corporation (FDIC)] determines are relevant to assessing such probability;
- (ii) the likely amount of any such loss; and
- (iii) the revenue needs of the deposit fund.⁷⁶

The FDIC uses this risk-based classification system as the legal basis from which to require banks to produce detailed reports and expert evaluations of the bank's financial condition. The FDIC's regulations require the agency to analyse objective "capital" factors as well as subjective "supervisory" factors.⁷⁷ The capital factors determine the institution's "capital group", which is one of five categories, signified as a 1, 2, 3, 4 or 5, in the risk classification.⁷⁸ The supervisory risk factors determine the institution's "supervisory sub-group", signified as A, B or C in the risk classification.⁷⁹ Further, the regulations provide that the FDIC will assign an institution a supervisory subgroup based on the FDIC's "consideration of supervisory evaluations provided by the institution's primary federal regulator".⁸⁰

The supervisor has the authority to act if the bank's capital drops into the lower three categories. The FDIC is required to appoint a conservator or receiver if the bank's capital drops to the lowest category, designated as "critically undercapitalised". The FDIC may exercise forbearance in exceptional circumstances where it has agreed with the relevant federal bank regulator that receivership or conservatorship would likely result in significant market turbulence and would further damage depositors' interest.⁸¹

The US prompt corrective action regime enhances legality by providing trigger points that determine when a particular regulatory action can be taken, thereby enhancing legal certainty while allowing the regulator the flexibility not to apply an enhanced regulatory measure if it might exacerbate market conditions (ie a financial crisis) or worsen depositors' interest. Shareholder expectations are thus enhanced by having their property rights subject to a

⁷⁶ 12 USC § 1817(b)(1)(C).

⁷⁷ *FDIC v Coughatta*, 930 F 2d 122 (5th Cir), cert denied, 502 US 857 (1991).

⁷⁸ A supervisor may classify a bank in one of the following categories: (1) *Well Capitalised* banks have a total risk-based capital ratio of at least 10%, a Tier 1 risk-based capital ratio of at least 6%, a leverage ratio of at least 5%, in which case they may not be subject to an order, written agreement or directive relating to capital; (2) *Adequately Capitalised* institutions have a total risk-based capital ratio of at least 8%, a Tier 1 risk-based capital ratio of at least 4% and a leverage ratio of at least 4% (or a leverage ratio of at least 3% if the institution has a supervisory rating of 1); (3) *Undercapitalised* institutions are those which fail to meet the requirements of an adequately capitalised institution; (4) *Significantly Undercapitalised* institutions are those with a total risk-based capital ratio of less than 6%, a Tier 1 risk-based capital ratio of less than 3% or a leverage ratio of less than 3%; and (5) *Critically Undercapitalised* institutions are those with a less than 2% tangible equity to total asset ratio.

⁷⁹ 12 CFR § 327.3 (e)(1).

⁸⁰ 12 CFR § 327.3(e)(1)(ii).

⁸¹ The relevant regulator and the FDIC must review their decision not to appoint a conservator or receiver once every 90 days.

prescriptive legislative and regulatory regime in which there are clear expectations about what will happen to their control and economic interests if the bank's conditions deteriorate. The expectation of the loss of control or the dilution of share value acts to discipline shareholders to exercise more effective oversight of bank management and to influence management to take less socially risky behaviour. Moreover, if the bank cannot be salvaged, the regulations providing for receivership or conservatorship allow for an efficient winding up of the bank with depositors being reimbursed from the deposit insurance fund and the FDIC acting as residual claimant on any surplus assets in the estate.

Financial liberalisation, securitisation and wholesale funding, and how they contributed to the recent financial crisis, raise important issues regarding how the principle of legality can be applied to regulate globalised and securitised financial markets where banks and financial firms are threatened equally, if not more, by liquidity risk, rather than credit risk.⁸² Liquidity in financial markets depends on there being a balance between risk absorbers (purchasers of assets) and risk traders (sellers of assets).⁸³ Funding liquidity depends on this balance being maintained, which requires that regulatory intervention not upset this balance, nor exacerbate the imbalance in a turbulent period.⁸⁴ To supervise firms in the area of liquidity risk management requires that shareholders invest their capital in lower yielding assets which can be more quickly liquidated at face value during a crisis. Prescriptive trigger points, as in prompt corrective action, may be inappropriate, but this does not preclude the use of other mechanical reference points, such as liquidity ratios and ratios of maturity mismatches in volatile asset classes. Liquidity risk supervision, however, should not focus exclusively on numerical reference points, but should also contain an ample level of regulatory discretion to allow the supervisor to adjust regulatory techniques in response to market developments and financial innovation. Although prescriptive regimes enhance legal certainty and the stability of expectations of market participants, they may prove obsolete rather quickly as the sources of systemic risk evolve in complex global markets. The one certain lesson that supervisors can take away from the credit crisis has been that bank failures can arise, along with virulent financial distress, from unexpected liquidity shocks that are unrelated to the balance sheet health and capital adequacy of the bank or financial institution. This type of liquidity freeze can occur without warning to shareholders and thus result in regulatory intervention where none was expected. This could potentially undermine the principle of legality as a criterion for regulatory intervention.

⁸² See K. Alexander, J. Eatwell, A. Persaud, and R. Reoch, "Financial Supervision and Crisis Management in the EU" (Brussels, EU Parliament, 2007), 2–4.

⁸³ *Ibid.*

⁸⁴ *Ibid.*, 23–26.

2. Regulatory Discretion and Due Process

Article 1 of Protocol 1 of the ECHR provides that shareholders should have reasonable opportunity and coherent procedures upon which to act in contesting regulatory actions which interfere with their property rights. The court considered the right to due process in *Olczak v Poland*,⁸⁵ where the shares held by the complaining shareholder had constituted approximated 45% of the bank's equity capital before the receivers appointed by the National Bank of Poland took control of the bank and reduced the nominal value of its share capital to cover some of the substantial losses which the bank had incurred. Following this, the receivers authorised the bank to issue a new class of non-transferable shares with extra voting rights which were subscribed to and paid for by the National Bank of Poland. The complaining shareholder, whose equity interest dropped to 0.4%, was prohibited from subscribing to any additional shares. The substantial dilution of the shareholder's ownership interest led to a corresponding loss of control over the affairs and management of the bank. The court ruled that, although the shareholder had standing to allege that its rights under Article 1 of Protocol 1 were infringed, the bank's substantial losses and irregular practices had put its customers' deposits at risk and its possible bankruptcy threatened the public interest by putting the financial system at risk.⁸⁶

In a financial crisis, a regulator may need to act quickly, and this can necessitate the setting aside of normal notice procedures for a party to contest a regulatory action. In *Capital Bank AD v Bulgaria*,⁸⁷ the Strasbourg Court ruled that the legitimacy of a regulator's decision to revoke a bank's licence without following normal procedures for notice and a hearing would depend on the nature of the crisis in question and whether it was reasonable and necessary to set aside the respondent party's due process rights before suffering a property deprivation.⁸⁸ An important factor would be whether a subsequent hearing held after the regulatory action was taken would not be too late by leading to irreparable damage to the bank's or shareholder's rights. The court observed that the principle of legality under the ECHR prohibits the state from taking arbitrary and capricious state action and requires that any action depriving a person or entity of its property be a proportionate measure that achieves the public interest.⁸⁹ Article 1 of Protocol 1 requires that procedural guarantees be in place to allow the individual or entity to contest the state action in question by presenting their views to an independent and impartial tribunal.

⁸⁵ ECtHR, No 30417/96 (decision of 7 November 2002).

⁸⁶ *Ibid.*, 17.

⁸⁷ *Capital Bank AD v Bulgaria*, ECtHR, No 49429/99, Final Judgment (24 November 2005) 3–6.

⁸⁸ *Ibid.*, 34–35. The court also observed that under emergency circumstances provisional measures may be taken pending a review of the bank's objections at a later hearing before a final decision is made. *Ibid.*, 36–37.

⁸⁹ See *Hasan and Chaush v Bulgaria*, judgment of the ECtHR of 26 October 2000.

The requirement for an impartial tribunal implicates article 6 of the ECHR, which provides: “In the determination of his civil rights and obligations . . . everyone is entitled to a fair and public hearing. . . by an independent and impartial tribunal established by law.”

The Strasbourg Court has interpreted property rights to be equivalent to civil rights within the meaning of Article 6(1) ECHR. Therefore, regulatory action that deprives a shareholder of its ownership interest in a company’s stock requires that fair procedures be available to the shareholder to object before an impartial tribunal. It is recognised, however, that such procedures can be set aside in exceptional circumstances in which it is necessary for regulatory action to be taken immediately, such as in a banking crisis or other financial market turbulence where the financial system may be at serious risk.⁹⁰

In addition, Article 13 ECHR provides: “Everyone whose rights and freedoms as set forth in [the] Convention are violated shall have an effective remedy before a national authority notwithstanding that the violation has been committed by persons acting in an official capacity.”

The right of access to court, however, may be restricted in exceptional circumstances where the state has a legitimate purpose and the means employed to achieve that purpose are proportionate. The determination of a legitimate purpose was at issue in *Camberrow MM5 AD v Bulgaria*,⁹¹ where the Strasbourg Court held that the bankruptcy trustee’s sale of an insolvent bank in an expedited manner and as a going concern without court approval was necessary to achieve a higher recovery for creditors, and that this justified the setting aside of the consultation and notice requirements of the insolvency procedure. Adhering to the insolvency procedures, which had required full consultations with all creditors and stakeholders over an extended period of time, would have jeopardised the quick sale of the bankrupt bank for a price satisfactory to most creditors. In its decision, the court reasoned that emergency state measures such as these “enjoy[ed] a wider margin of appreciation” if they were taken “in delicate economic areas such as the stability of the banking system”. It concluded that it was not disproportionate for the regulator to restrict the participation of shareholders in the negotiations over the insolvent bank’s estate if the result was that the bank could be sold promptly as a going concern while providing a higher recovery for creditors from the bankruptcy estate.

Shareholder rights can also be implicated by the type and scope of judicial review available to challenge regulatory action. Article 6 ECHR requires judicial review of the exercise of state administrative decisions that interfere with property rights. This means that regulatory action that is upheld by an administrative tribunal must still be subject to judicial review *de novo* on questions of fact

⁹⁰ *Olczak v Poland*, supra n 21, 17–18.

⁹¹ *Camberrow MM5 AD v Bulgaria*, ECtHR, Decision on Admissibility (1 April 2004).

and issues of law that relate to the dispute.⁹² In *Credit and Industrial Bank v the Czech Republic*,⁹³ the court ruled that the limited scope of judicial review available under Czech law to challenge the insolvency administrator's factual determination of compulsory administration for a Czech bank had violated Article 6(1) on the grounds that the bank's controlling shareholder who had challenged the determination was left with no option but to appeal the finding to an administrative or judicial tribunal.

In contrast, shareholders in US banks have narrower grounds to challenge regulatory decisions and actions under US banking law. For instance, US courts have examined whether FDIC procedures for issuing capital directives to banks satisfied due process requirements of the US Constitution. The Fifth Circuit Court Appeals held in *FDIC v Coughatta*⁹⁴ that the FDIC must adhere to a three-factor inquiry that courts are required to use in determining what type of procedures satisfy due process before the government may deprive an entity of a property interest protected by the Due Process Clause of the Fifth or Fourteenth Amendments.⁹⁵ The three factors are: (i) the private interest that will be affected by the official action; (ii) the risk of an erroneous deprivation of such interest through the procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and (iii) the government's interest, including the function involved and the fiscal and administrative burdens that the additional or substitute requirement would entail.⁹⁶ Essentially, due process is flexible and calls for such procedural protections as the particular situation demands.⁹⁷

In assessing prudential supervisory practices, the Fifth Circuit in *Coughatta* concluded that procedures for determining capital adequacy and risk-based supervisory ratings satisfied due process. The court reasoned that the private interest of accurate capital directives is significant but that the risk of an erroneous deprivation of property because of the application of a directive is marginal. The court noted that a pre-deprivation evidentiary hearing (as opposed to an informal hearing) was not warranted because a bank has adequate opportunity to respond to the notice through written procedures. Also, the court found that the government's interests were substantial because delay would considerably weaken the benefits from a prompt directive, which would seek to

⁹² Art 6 ECHR requires that such decisions must be subject to subsequent control by a "judicial body that has full jurisdiction". See *Obermeier v Austria*, judgment of the European Court of Human Rights of 28 June 1990 (holding that violations of Art 6(1) can occur when courts of first instance rule that they are bound by determinations of material facts by administrative tribunals).

⁹³ *Credit and Industrial Bank v the Czech Republic*, ECtHR, No 29010/95, Final Judgment (21 October 2003) 19–22.

⁹⁴ 930 F 2d 122 (5th Cir), cert denied, 502 US 857 (1991).

⁹⁵ The fundamental requirement of due process is the opportunity to be heard "at a meaningful time and in a meaningful manner". *Matthews v Eldridge*, 424 US 319, 333 (1976).

⁹⁶ *Coughatta*, *supra* n 77, 335.

⁹⁷ *Ibid*, 334.

rectify a bank's troublesome undercapitalisation. Similarly, in *Doolin*, the Fourth Circuit reviewed the procedures allowing a bank to challenge an FDIC determination of risk-based capital ratings, and found the procedure to be in compliance with constitutional standards of due process.⁹⁸

The FDIC procedure allowing banks to contest their risk-based capital ratings meets the due process test because it provides banks with notice of their risk classifications and an opportunity to challenge the classification through the review procedures established in the regulations.⁹⁹ Accordingly, the courts have held that the due process clause does not require a pre-deprivation evidentiary hearing before a particular risk-based weighting is applied to banks' capital position.¹⁰⁰

Similarly, the Office of Thrift Supervision (OTS)¹⁰¹ has discretion to determine whether the business activities of savings banks are "unsafe or unsound practices" and thus in violation of prudential supervisory standards of federal banking law. Such determinations may only be overruled by a court if it concludes that the agency action was arbitrary, capricious or an abuse of discretion, and that there is insufficient evidence to overcome the presumption of regularity and correctness afforded to the appointment. The courts have generally upheld the discretionary authority of the OTS to apply prudential supervisory standards to federal savings banks that rely on a combination of objective and subjective standards for determining whether the bank was acting in a prudential manner.¹⁰² These prudential assessments produce specific composite ratings of each savings bank. Banks may challenge the risk-based assessments that are applied to their activities by the OTS. The review procedure involves a three-tier administrative review whereby an institution may challenge its risk-based ratings at the district level of the OTS, and then may appeal the decision to the OTS Director. Once administrative review with the OTS is exhausted, an institution may seek review before an administrative law judge pursuant to the Administrative Procedure Act.¹⁰³

Under the above legislation and regulations, US bank regulators have broader discretion than their European counterparts to require a bank to recapitalise itself and establish higher capital levels, and to change the bank's business behav-

⁹⁸ The FDIC procedures allow the bank to submit the request and supporting documentation to the FDIC Division of Supervision. The procedures also provide for an opportunity to request an informal oral hearing, which the FDIC may grant, in its discretion, "when the Division of Supervision determines that an informal oral presentation would be productive under the applicable circumstances". 58 Fed Reg 34357, 34359 (25 June 1993).

⁹⁹ 12 CFR § 327.3.

¹⁰⁰ *Doolin*, 53 F 3d, 1403.

¹⁰¹ The OTS regulates and applies prudential supervisory standards to the operations of federal savings banks that are not regulated by the Comptroller (Treasury) or by the Federal Reserve Board.

¹⁰² See *Doolin*, *supra* n 100, 1405.

¹⁰³ 5 USC 702 (1998)(provides general right to judicial review of agency action).

ious if its activities constitute, in the regulator's view, "unsafe and unsound" banking practices.¹⁰⁴ The contrasting approaches taken by the Strasbourg Court and US Courts regarding the scope of judicial review that shareholders can expect when regulatory action interferes with their property rights suggests that European regulators may be more constrained and limited in the measures they may adopt to achieve regulatory objectives, which could potentially undermine the standard of banking supervision that is needed in today's turbulent markets. Nevertheless, the Strasbourg Court has also recognised the principle of the margin of appreciation which allows states some discretion in devising their legal and regulatory frameworks so as to comply with the fundamental principles of the ECHR. Nevertheless, European law must provide individuals and business entities with remedies to challenge administrative decisions on both factual and legal grounds. Such remedies may lead to tribunals and courts deciding issues involving specialised knowledge and expertise that is beyond their technical capacities. In such cases, it should be considered that European states can establish adjudicatory bodies with *de novo* review to examine the decisions and actions taken by regulators to determine whether such regulatory intervention is necessary if it infringes any fundamental principles of the ECHR, such as the protection of shareholder property rights. Although the establishment of appropriate tribunals is necessary to comply with Article 6, this should be balanced by the need to have an expedited appeals process with time limits to achieve legal finality.

3. Compensation for Interference with Shareholder Rights

Regulatory actions must also be considered with respect to any damages or losses they impose on shareholders and third parties. Compensation terms should be an important element in determining whether regulatory action is justifiable and does not impose a disproportionate burden on specific individuals. The Strasbourg Court has ruled that a government may expropriate private property, but only on the condition that it pays adequate compensation, and that failure to do so would be a disproportionate interference with property rights.¹⁰⁵ In 1990 a Dutch court ruled that, although minority shareholders in *Nationale-Nederlanden* and *NMB-Postbank* respectively were entitled to compensation after they refused to sell their minority interests to the offering purchaser *Internationale Nederlanden Groep NV*, they were not entitled to have their compensation determined by a valuation method that was most beneficial to them. The temporary UK banking legislation enacted in 2008 provided that shareholders were entitled to receive compensation if their shares were

¹⁰⁴ 12 USC § 1818 (ii).

¹⁰⁵ *Former King of Greece and Others v Greece*, judgment of the European Court of Human Rights of 23 November 2000. See also *Offerhaus and Offerhaus*, *supra* n 48, 4–6 (acknowledging the right of shareholders who hand over their shares in a merger to receive fair compensation).

transferred by HM Treasury to a public authority or private party.¹⁰⁶ Under US federal banking law, shareholders are entitled to receive the fair value of their equity interest at the time of the appointment of a receiver. French law also provides that, upon the application of the Banking Commission to obtain a court-ordered share transfer, shareholders are entitled to apply for compensation from the Commission.¹⁰⁷

4. Limited Liability and Shareholder Rights

The principle of limited liability holds that shareholders are only personally liable for the debts of the company to the extent of the value of their investment in the company.¹⁰⁸ As a general matter, creditors or other third party claimants may not pierce the veil of incorporation with a private law claim to reach the personal assets of investors which exceed the amount they invested in the company except in narrowly defined circumstances.¹⁰⁹ However, the public regulatory law of many jurisdictions has afforded a growing number of remedies for state agencies, regulatory bodies and private claimants to so recover assets from parent companies and other controlling shareholders which exceed the amount invested in the company. For example, under the National Banking Act of 1863, the investors in banking corporations with federal charters were subject to double liability based on the par value of the shares they owned. Similarly, in the late nineteenth and early twentieth centuries many US states had double and triple liability statutes for investors who owned shares in state-chartered banks. In an era when there was no deposit insurance, the rationale behind these statutes was to provide depositors and other bank creditors with the possibility of recovering losses against bank shareholders that exceeded the value of what they had invested in the bank. In the 1930s, federal banking legislation established the first US governmental deposit insurance scheme and rescinded and pre-empted previous federal and state banking laws respectively that had imposed limitations on the principle of limited liability for shareholders.

¹⁰⁶ The Banking (Special Provisions) Act 2008. This temporary UK banking legislation expired in February 2009 and was replaced by the Banking Act 2009; it required the Treasury to establish procedures for compensating shareholders or creditors within three months of a property transfer order being made by the Treasury under the regime.

¹⁰⁷ Art L613-25 of the Monetary and Financial Code.

¹⁰⁸ See *Sea Land Services, Inc v Pepper Source* 941 F 2d 519, after remand, 993 F2d 1309 (7th Cir 1993) (discussing veil piercing principles under US law). In contrast, the *Salomon* principle in English law has been faithfully adhered to. See *Salomon v A Salomon & Co Ltd* (1897) (HL) AC 22. English courts have been reluctant to lower the barriers for a plaintiff seeking to lift the corporate veil.

¹⁰⁹ Piercing the corporate veil will involve the application of equitable principles and ordinarily depend on the facts of each case. US courts have been more lenient than English courts in allowing veil piercing and usually require the presence of two factors: a grossly undercapitalised company that disregarded corporate formalities, and which caused basic unfairness to the plaintiff. See Pinto and Branson, *supra* n 33, 40.

In the 1970s, public regulatory law began to extend its regulatory requirements beyond the corporate and business entities over which they directly applied to include any investors who were defined under the federal regulatory regime as owning a controlling interest, or exercising control in some other way, in a regulated firm or institution.¹¹⁰ This has had the effect of limiting the application of the principle of limited liability by exposing certain investors in regulated companies to potential liability that exceeds the value of their investments for regulatory breach against both the government and private claimants. For instance, in US banking and thrift regulation, US regulators have imposed prudential regulatory requirements on parent companies, affiliates or individuals who own or control at least 5% of the shares of a regulated financial institution.¹¹¹ Specifically, the US Supreme Court held in *Board of Governors v First Lincolnwood*¹¹² that the Board of Governors had the authority to assess the financial and managerial soundness of a company which had applied to purchase a controlling interest in a bank corporation.¹¹³ The court upheld the Board's denial of the application on the grounds that the prospective investor was, in the Board's view, financially unsound and "would not be a sufficient source of financial and managerial strength to its subsidiary bank".¹¹⁴ In addition, another aspect of the source of strength doctrine occurs when US regulators determine that a bank is failing, or has failed, in which case they have authority to compel existing controlling shareholders to downstream additional capital into the ailing bank.¹¹⁵ In other words, the Board of Governors has authority to issue directives requiring shareholders to invest substantial amounts in addition to what they have already invested in a banking institution if the regulator determines that the investors should provide further financial support.

The limitations on the principle of limited liability that occur under US regulatory law in the form of the source of strength doctrine and other regulations do not have an equivalent in European regulatory practice. Institutional

¹¹⁰ See PI Blumberg and KA Strasser, *The Law of Corporate Groups* (Boston, Little Brown, 1992).

¹¹¹ See H Jackson, "The Expanding Obligations of Financial Holding Companies" (1994) 107 *Harvard Law Review* 507, 517–25 (discussing the extension of federal regulation to thrift and bank holding companies respectively).

¹¹² 439 US 234 (1978).

¹¹³ See M Schinski and DJ Mullineux, "The Impact of the Federal Reserve's Source of Strength Policy on Bank Holding Companies" (1995) 35 *Quarterly Review of Economics and Finance* 483; L Bierman and DR Fraser, "The 'Source of Strength' Doctrine: Formulating the Future of America's Financial Markets" (1993) 12 *Annual Review of Banking Law* 269.

¹¹⁴ *Board of Governors v First Lincolnwood Corp.*, *supra* n 112, 253. See also *Irving Bank Corp v Board of Governors*, 845 F2d 1035 (DC Cir 1988) (where the Board imposed financial conditions on the approval of an application by a bank holding company to acquire control of a bank and the conditions required the holding company to achieve specific capital levels).

¹¹⁵ In 1984 the Board adopted Regulation Y, which provides in § 225.4 Corporate Practices: *Bank holding company policy and operations*. (1) A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct [sic] its operations in an unsafe or sound manner.

investors in EU companies and banks are largely protected from regulatory liability or other private civil claims for regulatory breach against the company to the extent of the value of their investment in the company. As special resolution regimes are amended in light of the present financial crisis, it is submitted that regulators outside the US may seek broader powers, similar to the source of strength doctrine, in order to require existing shareholders in banks to demonstrate their capacity beyond what they have invested in the bank to be a source of strength. In exceptional circumstances, policymakers may find it necessary in order to protect depositors and maintain financial stability to pierce the corporate veil of an ailing bank so as to compel some of its shareholders to downstream capital to the bank.

5. Special Resolution Regimes and the UK Approach

A special resolution regime for banks should respect the principles of legality, due process, limited liability and adequate compensation. At the same time, the regulatory regime should provide incentives for shareholders, directors and management to act in a way that protects depositors and maintains confidence in the banking sector, while achieving a market-based solution to find investors for a failing bank or disposing of the bank's viable assets if the bank cannot be saved.¹¹⁶

Commentators have generally agreed that three types of packages are appropriate in the situation of a failing bank.¹¹⁷ The first is known as a pre-packaged resolution which makes use of the company's governance rules, while the second approach allows the bank to exist temporarily while also temporarily suspending shareholder rights. The third approach would terminate the rights of shareholders altogether. The three approaches all rely on a capital restructuring to save a failing bank and could be combined or substituted if efforts to save a failing bank become impracticable and depositor protection and an orderly winding without market disruption become the primary objectives.

¹¹⁶ In 1987, the Board issued its source of strength policy:

"It is the policy of the Board that in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. . .

A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary bank(s), including an unwillingness to provide appropriate assistance to a troubled or failing bank, will generally be considered an unsafe or unsound banking practice in violation of Regulation Y, or both." See Policy Statement, 52 Fed Reg 15707, 15708 (1987).

¹¹⁷ See E Hupkes, "Bank Insolvency: the last frontier" in D Mayes, R Pringle and M Taylor (eds), *Towards a New Framework for Financial Stability* (London, Central Banking Publications Ltd, 2009), 185, 194–95.

6. The UK Banking Act 2009 and Shareholder Rights

The Banking Act 2009 introduces a special resolution regime that provides the FSA, the Bank of England and HM Treasury—also known as the tripartite authorities¹¹⁸—with new powers to deal with failing banks. Specifically, the Act grants the Treasury and the Bank of England sweeping powers to restructure a failing bank by transferring shares and property to a government-owned bridge bank or private purchaser.¹¹⁹ The Act also provides a mechanism to compensate shareholders, depositors and third party creditors.¹²⁰

The stabilisation powers consists of three areas: (i) pre-insolvency stabilisation powers; (ii) a bank insolvency procedure; and (iii) a bank administration procedure.¹²¹ The Bank of England has the sole responsibility for exercising the stabilisation powers that include: transfers of shares and any other property (including partial property transfers) owned by the failing bank to either a private sector purchaser or a bridge bank, or into temporary public ownership. In exercising these powers, the Bank would have authority to appoint a temporary administrator to manage the affairs of a bank taken into public ownership, or to administer the residual assets of a bank from which shares and property were transferred to a government-owned bridge bank or to a private purchaser.

The FSA would have the responsibility for determining whether the pre-conditions for use of the stabilisation powers and the bank insolvency procedures have been met.¹²² Section 7 sets out the two main conditions that trigger the special resolution regime (SRR): (I) the bank is failing or is likely to fail, and has failed to satisfy the threshold conditions for permission to carry on regulated activities set out in the Financial Services and Markets Act 2000;¹²³ and (ii) it is not reasonably likely that without the stabilisation powers the bank can take action to satisfy the threshold conditions.¹²⁴ The FSA would have to

¹¹⁸ The memorandum of understanding between the tripartite authorities establishes a standing committee. See www.publications.parliament.uk/pa/cm200708/cmbills/170/2008170.pdf.

¹¹⁹ Banking Act 2009, ss 11 and 12.

¹²⁰ *Ibid.*, s 27.

¹²¹ The SRR applies to UK-incorporated banks that have permission from the FSA to accept deposits and banking group holding companies incorporated in the UK which owned bank subsidiaries operating in other jurisdictions. The regime does not apply to foreign-owned branches of banks incorporated in other EEA states (including Icelandic banks).

¹²² The UK Banking Act 2009 requires that the FSA make the decision after consultation with the Bank of England and the HM Treasury. The involvement of three separate authorities in the decision should help ensure that it is balanced and enjoys wider legitimacy. The Banking Act 2009, s 12.

¹²³ Financial Services and Markets Act 2000, s 41(1).

¹²⁴ The Banking Act 2009, s 7(3). The FSA is required to ignore the effect of any financial assistance provided to the bank by the Treasury and the Bank of England; however, it does not include temporary financial support provided by the Bank of England in its open market operations offered on ordinary terms.

determine that the threshold conditions¹²⁵ have been met before the SRR can become operational, with the result that the Bank of England can then exercise the stabilisation powers. The Treasury is responsible for any decision involving the use of public funds which might be required as a result of the Bank's exercise of special resolution tools. The Treasury can also use public funds to compensate shareholders or third party creditors who can demonstrate that they have suffered losses by having their shares or property—transferred either fully or partially—to a bridge bank or to a private purchaser.¹²⁶

The SRR provides for certain departures from general corporate governance arrangements. The bank administration procedure allows for special administration or conservatorship under which all corporate bodies—the board and management—are suspended and an appointed official temporarily takes control of the bank's operations. The powers of the temporary administrator also extend, however, to the shareholders' power to determine changes to the bank's capital structure by suspending all such shareholder rights during administration. As discussed earlier, EU company law requires that measures affecting a bank's capital structure, such as a capital increase or a merger with another bank, are to be decided by shareholders. The ECJ ruled in *Pafitis*¹²⁷ that the Second Company Law Directive precludes national legislation which allows an administrator to order a recapitalisation of an under-capitalised bank without shareholder resolution and approval at a meeting. Similarly, the ECJ ruled in the *Kefalas* case¹²⁸ that “the decision-making power of the general meeting provided for in Article 25(1) applies even where the company is experiencing serious financial difficulties”. A reorganisation involving a change in capital structure therefore requires a vote of approval by shareholders at a general or special meeting.

The powers provided to the Bank of England and to HM Treasury under the special resolution regime to set aside these shareholder rights suggest that bank

¹²⁵ See also Threshold Conditions (Banking Act 2009) Instrument 2009. For a description of what is covered by the threshold conditions and how they are applied, see the FSA Handbook, available at <http://fsahandbook.info/FSA/html/handbook/COND/2>.

¹²⁶ Banking Act 2009, ss 54–56. Moreover, the transfer of shares or property of a bank corporation to a bridge bank or to another private company or firm without shareholder approval could potentially violate Arts 5 and 6 of the Sixth Council Directive, which requires shareholder approval for the division of a public limited liability company. Sixth Council Directive 82/891/EEC of 17 December 1982, [1982] OJ L 378, 47–54 (Arts 5 and 6 on company spinoffs).

¹²⁷ The ECJ ruled in *Pafitis* that the directive does

“not preclude the taking of execution measures intended to put an end to the company's existence and, in particular, does not preclude liquidation measures placing the company under compulsory administration with a view to safeguarding the rights of creditors. However, the directive continues to apply where ordinary reorganization measures are taken in order to ensure the survival of the company, even if those measures mean that the shareholders and the normal organs of the company are temporarily divested of their powers.”

¹²⁸ C-367/96 *Kefalas and Others v Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* [1998] ECR I-2843.

shareholders would have a strong legal basis to bring a claim under Article 25 of the Second Directive.

Another approach could be made on the policy front by considering whether the Second Directive should be amended to allow a quick recapitalisation by a temporary administrator from other investors when an individual bank is faced with a sudden loss of confidence or when there is a declared financial crisis. This would allow the special administrator in the SRR to have greater powers in the event of the deterioration in the condition of a bank. The effect of this may not be so deleterious for shareholders, as they often have accepted a dilution of control and share value in connection with capital raisings in the present crisis.¹²⁹ Yet it may be more legitimate, based on the legal principles discussed above, to allow a public regulatory authority to impose a capital raising without shareholder approval if the decision is based on clear criteria and agreed regulatory standards. A regulator or other state authority could ensure that shareholders are afforded due process and the decision is based on coherent and legitimate requirements. If shareholders suffer losses, they should be compensated, as is required under the UK Banking Act, based on principles of equal treatment. Under this approach, the shareholders' control and economic rights may be significantly reduced, but they would retain a diluted interest in their bank along with an upside gain if the bank recovers and leaves administration. The alternative would be shareholders insisting on full adherence to their right of approval to any capital change, but with the risk that without the protections of the special resolution regime the shareholders will lose all their interests in a collapsed bank.

G. CONCLUSIONS

The financial market turbulence of 2007–09 has raised important concerns regarding the intensity of bank regulation and the extent to which regulatory measures should infringe property rights in banking institutions. European law provides strong property protection rights for bank shareholders, while US law provides more limited protections. Although it is recognised that regulators should be able to act quickly in a crisis, shareholders have legitimate rights which should be protected. The exercise of prudential regulatory authority without consideration of the principles of legality, due process, compensation, and limited liability may infringe shareholder rights in banking corporations. These rights, however, must be weighed against the interests of other stakeholders and

¹²⁹ This was the case with Barclays, the Lloyd's Banking Group and Halifax Bank of Scotland in November and December 2008, when their shareholders all voted to accept substantial increases in capital. See E Ferran, "Bailouts of Ailing Banks through Capital Injections" (9 December 2008), 6–8. Copy on file with author.

wider regulatory objectives to protect financial stability. Balancing these interests creates challenges for designing a bank resolution framework. The challenges are particularly great when dealing with failing banks which perform functions essential for the economy. The UK Banking Act 2009 sets forth a new regime to reorganise failing banks and to take failed banks into administration or liquidation. The Act adopts a special resolution regime that contains stabilisation powers for the Bank of England to transfer property and shares from a failing bank to a bridge bank or private bank. Although these powers might infringe shareholder rights in a failing bank, the exercise of these powers has the objective of striking a balance between the legitimate rights of shareholders and depositors while promoting financial stability objectives. The UK regime provides a model for how other states can manage the uncertainties of the present financial climate, but nevertheless reform of EU Company Law may be necessary to bring this to fruition.